

**DEPARTMENT OF STATE REVENUE  
LETTER OF FINDINGS NUMBER: 00-0137  
ADJUSTED GROSS INCOME TAX  
For Years 1994, 1995, 1996, AND 1997**

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**ISSUES**

**I. Adjusted Gross Income Tax—Loss flow through from S-Corporation**

**Authority:** 45 IAC 3.1-1-6; IRC 465

Taxpayers protest the denial of the flow through of their losses from their S-corporation to their individual return.

**STATEMENT OF FACTS**

Taxpayers are individuals who are eligible to file a joint income tax return for both federal and state income tax purposes. Taxpayers are the sole shareholders of two businesses, one of which is a retail sales outlet that was organized as a sub chapter S Corporation and sustained significant net operating losses which taxpayers flowed through to their individual return. The audit disallowed some of the losses inasmuch as the taxpayer was unable to provide all records necessary to accurately determine the amounts each shareholder had at-risk in the corporation. A timely protest was filed, with this letter of finding resulting.

**I. Adjusted Gross Income Tax—Adequate Documentation**

**DISCUSSION**

Taxpayer received an adjustment to their returns for the years at issue based on the Department's denial of their claim for losses flowing through to their individual return from their S-Corporation. The Taxpayer and Department agree that the issue centers on taxpayer's risk of loss for the S-Corporation losses and their flow through as outlined in 45 IAC 3.1-1-6. Specifically, both parties agree that IRC Section 465 specifies that a shareholder may only deduct losses to the extent that shareholder is at risk. While S-corporation shareholders are generally not at-risk for amounts borrowed by the S-corporation from third parties, S-corporation shareholders are at-risk for amounts personally borrowed from a bank and then loaned or contributed to the corporation. The Department and taxpayer agree that the money was actually a

monetary loss by the S-corporation and thus, potentially, qualifies as a loss to flow through to the taxpayer.

With this understanding, the issue becomes a burden of proof. While there is no dispute as to the loss amount for the S-corporation, IRC 465(b)(4) provides that a taxpayer is not at risk for amounts lost that are protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements. Taxpayer has now provided evidence to the effect that the loss did directly impact the shareholders and that they were not protected by the arrangements outlined in IRC 465(b)(4). Consequently, taxpayer protest is sustained.

### **FINDING**

Taxpayer's protest is sustained.

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